STOCKS OF FINANCIAL INSTITUTIONS

By L. A. Norton,
New York City.

In considering this field for investment, we may say at the outset that its importance is very apt to be underrated, because of the fact that the stocks of financial institutions are not as a rule the subject of active speculation upon the great stock exchanges, and accordingly the attention of investors is not attracted to them daily, as in the case of railroad stocks, by market reports and an abundance of newspaper comment.

While it is difficult to estimate with any exactness the total volume of these securities, we have in the case of national banks an exact compilation made by the Comptroller of the Currency, as of January 31, 1910, which shows that on that date there were in the United States 7045 national banks, and that the aggregate of their capital, surplus and undivided profits was as follows:

Capital stock	$960,124,895
Surplus	619,838,370
Undivided profits	199,342,082
Total	$1,779,305,347

It is usually estimated that the capital invested in state banks and trust companies throughout the country is nearly equal to that invested in the national banks, and if we add to this the amount invested in fire insurance companies, surety and casualty companies, title insurance and mortgage companies, we may perhaps conservatively estimate the total volume of the stocks of financial institutions in the United States as represented by book value to be somewhere between $3,500,000,000 and $4,000,000,000. But as it is almost impossible to grasp the significance of such immense figures, except by comparison, we may say roughly that the amount invested in these securities is probably somewhere between twenty per cent. and twenty-five per cent. of the total investment in the stocks and bonds of the steam railroads of the United States.

The volume of these securities is then important enough so

that an analysis of their characteristics may well claim our attention. In a prospective investment the investor always looks for four great cardinal features: First, security; second, income return; third, appreciation in value; fourth, marketability.

The relative stress of his requirements as to each of these features will depend first upon his temperament and second upon his circumstances. His success in finding securities which really meet the requirements he has set for himself will depend partly upon the information available, partly upon his ability to analyze and weigh the information which he obtains, and mostly upon his general judgment.

As the different classes of financial institutions differ widely in many of their general characteristics, we can perhaps best consider each class by itself, comparing first the stocks of this class with other general classes of securities and then establishing, if possible, some broad outlines of analysis that may be of assistance in determining what particular stocks of the class are most likely to meet the requirements of the investor.

Taking up first the national banks, let us consider their characteristics in comparison with other investments, as to the four general features above noted.

First as to security; when we consider the facts that in buying the stock of almost any well established and prosperous bank, it is necessary to pay a high premium over its par value, that the liability of the stockholder is not limited to the amount paid for his stock, but in the event of the bank's failure or impairment of capital, he is liable for an additional assessment equal to the par value of his stock or such amount thereof as may be necessary to meet the obligations of the bank in full; and that the success or failure of the institution is absolutely dependent upon the integrity and the judgment of its officers and directors, the first impression is apt to be that the investment is extra hazardous.

For these reasons the personal element enters more largely into consideration in bank stock investments than it does in almost any other class of securities; in fact, it is the all important element and it is absolutely essential that the investor who would buy bank stock with discrimination should know the reputation and the record of the men who are managing the affairs of the bank in whose stock he wishes to invest. It is for these reasons also that the investment

clientage for any given bank stock increases as a rule very slowly and is generally made up largely of people who either live in the immediate vicinity or who have had opportunities of personal acquaintance with the management.

But, on the other hand, there is perhaps no other line of business which is subjected to such constant and rigid scrutiny by the government as a protection for both depositors and stockholders. Five times a year each national bank is required to make a full report to the comptroller of the currency, showing its resources and liabilities as of a date determined by the comptroller and not known by the banks in advance of the call. Detailed examinations of each bank are also made at frequent intervals by the United States bank examiners and their findings are reported to the comptroller, who is given full power to compel compliance with the law. The result of this system of close scrutiny has been that the percentage of failures among national banks is very small and as a consequence the stocks of these institutions have proved themselves to be, in general, exceptionally secure as investments.

As to income return, the law requires that ten per cent. of net earnings for each half year shall be carried to surplus fund before the declaration of any dividend, until such surplus fund shall amount to twenty per centum of the capital stock, and as it is the general custom among national banks to declare in dividends in ordinary years only a portion of the earnings and to carry the remainder either as surplus, or as undivided profits, the immediate yield in dividends is generally low, as compared with the price paid for the stock. But as the amount so added to surplus increases the earning power of the bank and makes the regularity of dividends more secure, and as the cumulative effect of these accretions frequently enables the bank to pay in time increased dividends, experience has proved that where too great a premium has not been paid, the ultimate yield in dividends has been generally satisfactory, and in many cases exceedingly gratifying.

As to Appreciation in Value. In the consideration of this feature, a distinction should be made between market value and intrinsic value as represented first by net assets, second by earning capacity. While we may safely assume that the average market value of these stocks as a class, if taken over a long period, will fairly represent their real value as compared with other invest-

ments, the question of the market value of any given stock at any given time is influenced so largely by sentiment and by other elements that cannot be measured and that bear no relation whatever to the intrinsic value, that any selection of these stocks with a view to immediate increase in market value is ordinarily a very difficult undertaking.

We can, however, measure with some degree of accuracy the annual increase in intrinsic value of a given stock for a period of years, and thus establish its normal rate of growth and earnings, which is perhaps the best measure of its investment value, and we know in general that the deposits in national banks in the United States have doubled in the past ten years, and accordingly that the banking business as a whole is showing a satisfactory rate of growth and development.

As to marketability. For the reasons noted above, the market for bank stocks is usually almost entirely a local market, and is seldom broad enough or ready enough to appeal to the speculator who trades in fluctuations rather than in values, but for this reason there is generally very little temptation to manipulate their prices, and quotations are accordingly a much better index of the real balance between supply and demand than in the case of stocks which have an active public market.

There is, of course, a great difference between different stock of any class as to degree of marketability, and this difference is perhaps as wide in the case of bank stocks as in almost any other class of securities, so that the investor will do well to make diligent inquiry in advance as to the general marketability of any particular stock which he contemplates purchasing. Some banks are owned almost entirely by one or two individuals, others by one or two families, and still others by one or two financial institutions. In such cases the market for the stock is of necessity an extremely narrow one, but where the distribution of a stock is normal and its earnings and dividends satisfactory, there is seldom any difficulty in finding a market ready enough to meet all reasonable requirements. In fact, it is often much more difficult to buy the stocks of prosperous banks in any quantity without bidding them up unreasonably than it is to sell without unreasonable concessions.

Having thus outlined the general characteristics of the stocks of national banks as a class, let us turn our attention briefly to the

practical question of the selection from the class of such individual stocks as are likely to prove satisfactory as investments.

As we have said above, the most important consideration in such selection is the personal character of the management, but having satisfied ourselves as to this, the next consideration should be the record of the bank as shown by its periodical statements. Referring again to the compilation issued by the comptroller of the currency, we have the whole number of national banks and the aggregate of each item of resources and liabilities. It is evident, then, that if we divide the aggregate of each of these items by the total number of banks, we can construct a typical statement which will represent the average bank.

As the number of banks shown by the statement of January 31, 1910, was 7045, it will be near enough for all practical purposes if we divide each item by 7000 and omit all figures less than $1000. This gives us the following statement for our average or type bank:

RESOURCES

		Per Cent of Total Resources.
Loans and discounts	$747,000	54.1
U. S. bonds to secure circulation	97,000	7.0
U. S. bonds to secure U. S. deposits	6,000	0.4
Other bonds to secure U. S. deposits	2,000	0.2
Bonds, securities, etc.	121,000	8.7
Due from national banks	57,000	4.1
Due from state banks, etc.	22,000	1.6
Due from reserve agents	101,000	7.3
Bills of other national banks	6,000	0.4
Cash	119,000	8.6
All other resources	106,000	7.6
Total resources	$1,384,000	100.0

LIABILITIES

		Per Cent. of Total Liabilities.
Capital stock	$137,000	9.9
Surplus	89,000	6.4
Undivided profits	28,000	2.0
National bank notes	95,000	6.9
Due other national banks	138,000	10.0
Due state banks	70,000	5.0
Due trust companies and savings banks	68,000	4.9
Due reserve agents	6,000	0.4

		Per Cent. of Total Liabilities.
Individual deposits	$741,000	53.5
U. S. deposits	5,000	0.4
Deposits of disbursing office	2,000	0.2
Bonds borrowed	5,000	0.4
Total liabilities	$1,384,000	100.0

We have no definite data as to average earnings from each item of resources, but from a general knowledge of conditions it is quite possible to estimate, not perhaps closely, but with some reasonable approximation what such earnings ought under normal circumstances to average.

We may, for example, estimate the average gross return from loans and discounts as five per cent., the average yield of United States bonds as two per cent., the average yield of bonds, securities, etc., held as investments by the bank as four per cent. The items "due from national banks and due from state banks" other than reserve agents represent in part checks and drafts in process of collection, and the return from these items is, of course, small; perhaps one per cent. would not be unreasonable. The average return from the item "due from reserve agents" we may estimate as two per cent. The item "bills of other national banks" represents loans to depositing banks, and as it is offset in our average statement by the item "due reserve agents," its consideration may be eliminated from both sides of the account. The item "cash," of course, yields no income return. The item "all other resources" represents banking house and other real estate, furniture and fixtures, foreign exchange and other miscellaneous accounts. It is accordingly very difficult to make even an approximate estimate of the return from this item. If we assume, however, that one-half of it is productive, and that this half may yield four per cent., it gives the average return for the whole item as two per cent. In addition to the return from above items, there is a revenue from collections and miscellaneous services which may perhaps average one-quarter of one per cent. of total resources. On the other side of the account, our total expenditures will be made up of interest, expenses, loans and taxes.

In the statement of liabilities the only items involving interest are the various deposit accounts and the item "bonds borrowed." The accounts "due other national banks, due state banks and due

trust companies and savings banks" we may group as deposits of other banks and estimate necessary interest charge as perhaps two per cent. The item of average interest on individual deposits is difficult to estimate, but if we assume that on one-half of these accounts no interest is paid and that on the other half it ought not to average over two per cent., we may perhaps safely estimate that the total interest charge on this item ought not to be over one per cent.

The item "bonds borrowed" is small, and if we estimate the interest charge at three per cent., we shall be near enough for practical purposes. If, now, we estimate that average annual expenses ought not to be over one per cent. of total resources, and that average annual losses should not exceed one-half per cent. of total resources, we can construct a theoretical income account for our average or type bank, as follows:

REVENUE

From loans and discounts	($747,000)	5%	$37,350
From U. S. bonds	($103,000)	2%	2,060
From other bonds, securities, etc.	($123,000)	4%	4,920
From accounts due from state and national banks other than reserve agents	($79,000)	1%	790
From accounts due from reserve agents	($101,000)	2%	2,020
From cash	($119,000)	0%	
From other resources	($106,000)	2%	2,120
From collections and miscellaneous service, ¼% total resources			3,460
Total			$52,720

EXPENDITURE

Interest on deposits of other banks	($276,000)	2%	$5,520
Interest on individual deposits	($741,000)	1%	7,410
Interest on bonds borrowed	($5,000)	3%	150
Expenses of institution 1% total resources			13,840
Losses written off ½% total resources			6,920
Balance for taxes, dividends and surplus			18,880
Total			$52,720

Let it be understood that this estimate is not intended to show with any great accuracy the average earnings of the national banks of the United States, but that it is intended only to illustrate a

method of analysis which will enable the investor to apply his own estimates to the statement of the particular bank whose stock he is investigating. If having modified these estimates in accordance with conditions which exist in the particular field of this bank's operation, he finds that its net earnings as reported for a series of years are about what his estimates would lead him to expect, he can be satisfied that the bank's funds are well handled.

If reported earnings are much smaller than his estimates would indicate, he can rest assured that either interest charges, expenses or losses are greater than they ought to be. If on the other hand, he finds reported earnings much larger than his estimates would indicate, he should be on his guard lest the management in the desire for excessive profit should be taking risks not consistent with good banking.

State banks in their general powers and functions are not materially different from national banks, except that they are without the power to issue circulating notes. As they are examined by and report to state instead of national officers, however, the thoroughness of their examinations and the effectiveness of their general supervision will depend largely upon the character and efficiency of the banking department of the particular state in which they are doing business.

Savings banks in New York, New Jersey and the New England states are mutual institutions, and not stock corporations. In most of the other states they are organized under the state banking law, and are essentially state banks. Trust companies are organized under state laws and are subject to examination and supervision by the banking department of the state in which they are doing business. Their powers and restrictions vary in accordance with the laws of their respective states. Speaking generally, they have a much broader scope as to the kinds of business they are permitted to do than either state or national banks. Their power to act as trustees for individuals and corporations gives them a field of operations which has in many cases proved to be a very profitable one.

They are generally restricted as to the investment of their capital, but not as to the investment of their surplus, and a result of these restrictions has been that in the organization of these companies and in such increases of capital as are made from time to time it has usually been found advisable to have a paid-in surplus

large in proportion to the capital. For this reason the stocks of these companies ordinarily sell at prices which to the casual observer look much higher than they really are, because these prices are expressed in percentage of par value and not in percentage of book value. For example, if a trust company has a capital of $1,000,000 and a surplus of $3,000,000, its book value is 400, and if its stock sells at 500, its price is really no higher in proportion to its net assets than the stock of a company having its capital paid up in full, but no surplus, would be at 125.

As these companies differ widely in the proportions of the various kinds of business done, an intelligent analysis of their statements requires a much more intimate knowledge of the special conditions under which each individual company is operating than in the case of either state or national banks. As very full reports are made to the state banking department, however, the necessary information for such analysis is usually obtainable.

Life insurance companies. The stocks of these companies need not, as a rule, be given much thought from an investment point of view, as the mutual companies have no stock and the present tendency of stock companies seems to be toward mutualization. In the case of the successful stock companies, moreover, the dividends which may be paid upon the stock are usually limited by law, and the selling prices of these stocks are ordinarily governed by considerations entirely apart from their pure investment value.

Fire insurance companies. There is a large and attractive field for investment in the stocks of these companies for the investor who can afford to take the necessary risks of the business. For it is a business which is in its nature profitable but hazardous. Through the law of averages the ordinary ratio of loss to risk can be pretty definitely established, but there is the ever-present danger of the occasional great conflagration which may wipe out in a few hours the accumulated profits of a number of years of successful business. Conservative management will, of course, by a proper distribution of the general risk over a wide territory guard against this conflagration hazard as a real danger to the solvency of the company, but the tendency of insurable value to congestion in narrow areas is so great that a certain amount of this risk seems to be necessary in the successful conduct of the business.

On the other hand, the fact that premiums are paid in advance

gives the companies the use at all times of a large fund in addition to their own capital and surplus, so that in most companies the investment feature of the business is almost as important a factor as the underwriting feature.

In the investigation of an investment of this class, then the investor will do well to study the record of a company through a series of years both as to its underwriting experience, the percentage of expenses and losses to premiums received, and as to its investment experience, and the percentage of income other than premiums to the total fund in hand. The data for such analysis is usually available, as these companies are under state supervision and are required to make annual reports; and there are unofficial compilations, readily obtainable, which give these items in comparative tables extending over a series of years.

Surety and casualty companies. The investment features of these stocks are in general similar to those of fire insurance stocks, except that the conflagration hazard is in their case replaced by the panic hazard.

Title insurance and mortgage companies. The business of insuring titles to real estate and that of selling real estate mortgages guaranteed as to principal and interest, though entirely distinct in theory, are practically so closely connected that they are usually carried on by two affiliated companies, each of which serves as a feeder for the other.

As it is necessary that such companies should have large capital in order that their guarantees may command respect, and as their business is of necessity local in its character, and to be profitable must be done in large volume, such companies have, as a rule, confined their operations to the larger cities. In New York they have been unusually successful, and their stocks are regarded very favorably.